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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958.

No. 161

GRAYBAR ELECTRIC COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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GRAYBAR ELECTRIC COMPANY, INC.,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner, Graybar Electric Company, Inc., hereafter called Graybar, prays that a writ of certiorari issue to review the decision and judgment of the United States Court of Appeals for the Second Circuit entered April 13, 1959.

Opinions Below.

The Opinion of the United States Tax Court filed February 11, 1958, and reported in 29 T.C. 818, the Opinion of the United States Circuit Court of Appeals for the Second Circuit filed April 13, 1959, not yet officially reported, affirming the Tax Court and, the second Opinion of the Circuit Court filed June 12, 1959, not yet officially reported, denying Graybar's Petition of April 24, 1959 for a rehearing are contained at pages 25, 160 and 177 respectively of the Record of which nine printed copies have been filed with the Petition.

By these Opinions the Tax Court and the Court of Appeals held that certain Special Death Benefit payments

made by Graybar, under its general compensatory "Plan for Employees' Pensions, Disability Benefits and Death Benefits", to the estates or beneficiaries of its deceased employees and pensioners which were deducted from its gross income by Graybar in its Income and Excess Profits Tax Returns for the years 1947 through 1950 were not properly deductible under Section 23(a) of the Internal Revenue Code of 1939 as reasonable compensation for personal services actually rendered.

The payments were made upon condition and consideration that the employees should have remained in the employ of Graybar until death or retirement after a minimum of 15 or 20 years. Both Courts held that the Special Death Benefit payments were made as additions to the repurchase price of the Company's stock paid by Graybar on its reacquisition of the shares from the estates of its deceased employees and pensioners pursuant to its repurchase option and were therefore not made as additional compensation to the employees from whose estates they were acquired. The Tax Court's decision (R. 29), affirmed by the Court of Appeals, assessed deficiencies against Graybar totalling $214,593.24, of which $138,115.19 remains in controversy.

Jurisdiction.

The jurisdiction of this Court is invoked under and conferred by 28 U. S. C., Section 1254. The date of the judgment sought to be reviewed and its time of entry is April 13, 1959. The date of the Court of Appeals' order denying Graybar's Petition for a rehearing is June 12, 1959.

Questions Presented.

Special Death Benefit payments, conceded to be reasonable *qua* compensation and not to constitute gifts, were made by Graybar as employer to the estates or beneficiaries designated by an Employees' Benefit Committee of deceased employees who had purchased Graybar's stock under Stock Purchase Plans entitling all employees to purchase stock in proportion to their salary, position held and length of service. Graybar is a 100% employee owned corporation.

Such Special Death Benefit payments were made by Graybar under an amendment of its general compensatory Plan for Employees' Pensions, Disability Benefits and Death Benefits. The payments were discretionary with Graybar but were made upon the express condition, and upon consideration, that the deceased employees should have continued to serve Graybar until their deaths or retirement after a minimum of 15 or 20 years.

The payments were made by Graybar after its reacquisition of the corporation's stock from the estates of such deceased employees pursuant to Graybar's option to repurchase the stock at $20 per share, the original purchase price to the deceased employees, subject to which repurchase option the shares were originally sold to the employees.

Such Special Death Benefit payments exceeded the repurchase option price of $20 per share, which was the fair market value of the shares, and were unsupported by any consideration other than the services of the employees. The payments were made by Graybar out of operating funds and were consistently deducted in its income tax returns as compensation for services.

(1) Did the holdings by the Tax Court and the Court of Appeals that the Special Death Benefit payments constituted an addition to the repurchase price of the stock preclude the excess of such payments over such fair market value of the stock from constituting compensation taxable to Graybar's employees as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 as amended and correspondingly deductible by Graybar as employer under Section 23(a) as compensation for services?

2. Under such circumstances, are the holdings of the Tax Court and the Court of Appeals that the Special Death Benefit payments in excess of such fair market value of the stock did not constitute such compensation because such payments were additions to the repurchase price of the stock, proper as a matter of law?

3. Under such circumstances, are the holdings of the Tax Court and the Court of Appeals that such Special Death Benefit payments in excess of such fair market value of the stock did not constitute compensation because some one or more of the employees who may have rendered the same or more meritorious services to Graybar as employer have failed to exercise their privilege of purchasing stock under its Stock Purchase Plans and thus were not entitled to, and did not receive, the benefit of such Special Death Benefit payments, proper as a matter of law?

Statute and Regulations Involved.

INTERNAL REVENUE CODE OF 1939:

> "SEC. 22(a). 'Gross income' includes gains, profits and income derived from salaries, wages or compensation for personal services * * * of whatever kind and in whatever form paid * * *."

"SEC. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * ."

Treasury Regulation 111, Sections 29.23(a)-6 and (a)-9, the pertinent provisions of which are contained in Appendix A annexed to this Petition.

Statement of the Case.

The facts of this case are all agreed and admitted facts embodied in a Stipulation, a Supplemental Stipulation and the Exhibits attached (R. 1-159). Only questions of law are involved.

100% employee ownership of Graybar's stock is, and since 1928 has been, distributed amongst an average of some 2,000 or more employees, or 60% of the total number of Graybar's employees. No single holding exceeds 1.8% of the stock (R. 4, 5, 15, 24, 26).

The stock is held by Graybar's employees under contractual provisions (R. 17) and provisions of Graybar's charter (R. 16), that no holder shall sell or dispose of such stock without first offering it for sale to Graybar at the price for which it was issued, namely $20 a share. Graybar has an option to repurchase the stock at its original issue price of $20 a share on the death of the holder

or in the event he should cease to be an employee of Graybar for any reason other than his retirement on a pension allowed by Graybar (R. 16, 17). It has been the Company's uniform practice to exercise its repurchase option in all instances (R. 24).

This 100% employee stock ownership of Graybar originated pursuant to its policy of adopting a series of employee Stock Purchase Plans. Under these Plans, Graybar's employees were given a right to purchase for cash shares of its Common Stock at $20 per share, subject to these restrictions and options (R. 17). Subscribers were limited (R. 17) to Graybar's employees but the Plans were open to all employees who had served the Company for at least six months (R. 43, 59, 72, 86, 94).

The employees' eligibility to purchase and the number of shares purchasable were based upon their respective lengths of service, the respective positions which they held and the respective amounts of the compensation or salaries which they received (R. 17).

Upon its incorporation in 1926 Graybar adopted a Plan for Employees' Pensions, Disability Benefits and Death Benefits as part of its general policy of compensating and paying various benefits to employees, pensioners and their beneficiaries (R. 101).

In 1941 the Plan was amended to authorize Graybar at the discretion of its Board of Directors and on the recommendation of its "Employees' Benefit Committee" to make Special Death Benefit Payments to relations of the deceased employee or such other beneficiaries as might be designated by the Committee (R. 122).

By the terms of the Plan, Special Death Benefits could be made only to the estates or beneficiaries of deceased employees or pensioners who had served Graybar as

employees until their death or their retirement after a minimum of 15 or 20 years (R. 102, 103).

During the taxable years 1947 through 1950, Graybar paid Special Death Benefits to the beneficiaries or the estates of approximately ninety-eight employees or pensioners as recommended by the Employee Benefit Committee and approved by its board of directors, in the amounts aggregating $214,593.24 (R. 38). The Special Death Benefit payments were based on the length of service, positions and total annual compensation of each such employee listed in Ex. 30-DD, the length of service rendered to Graybar by these ninety-eight employees being in most instances over 20 years and in some instances 40 to 50 years (R. 17, 150).

The payments were made from Graybar's operating funds and were deducted in its income tax returns for the years in question as compensation for services rendered.

The Commissioner, without admitting that the payments were compensation, conceded by stipulation in the Tax Court that "said payments shall not be disallowed as deductions from gross income on the ground that the same constitute unreasonable allowances for compensation for personal services" (R. 39).

In his Brief in the Court of Appeals the Commissioner conceded that "under no conceivable circumstances can the payments in issue (i. e., the Special Death Benefit payments) be considered a gift • • •".

Reasons Relied on for the Allowance of the Writ and Supporting Argument.

A.

The Decisions Below are in Direct Conflict with the Principles of the Decisions of this Court in *Commissioner* v. *LoBue*, 351 U. S. 243, *Commissioner* v. *Smith*, 324 U. S. 177 and *Helvering* v. *Salvage*, 296 U. S. 106.

(1)

It is admitted and found that under the provisions of the Stock Purchase Plans, Graybar retained an option to repurchase the stock at no more than $20 a share. By necessity therefore any increase in the repurchase price over $20 a share, unless supported by some consideration, would have been a gift. Since, however, under the stipulated facts, the finding of the Tax Court and the concession of the Commissioner in its Brief in the Court of Appeals the payments were not gifts, some consideration therefor must of necessity be found. It is a legal and factual impossibility to find any consideration for the Special Death Benefit payments, regarded as they were by both lower Courts as additions to the $20 per share repurchase price of the stock, other than the services of the employees, nor did either the Tax Court or the Court of Appeals find any such other consideration therefor.

Since it is conceded by the Commissioner that the Special Death Benefits were not gifts the holdings below are in direct conflict with this Court's holding in *LoBue* that since the transaction there (247) "was not a gift, it seems impossible to say that it was not compensation"; "the company was not giving something away for nothing" (247). "When assets are transferred by a an employer to an employee to secure better services they are plainly

compensation" (247). "LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to get better work from him. This is 'compensation for personal service' within the meaning of Section 22(a)" (247).

Here, as in *LoBue*, the object of the employer was "to secure more profitable operations by providing the employees with incentive to promote the growth of the Company by permitting them to participate in its success (246)." In *LoBue* the method used was a stock option plan which enabled selected key employees to purchase Company stock at a fixed price regardless of subsequent increases in its value. Here, for the same purposes, Graybar used its Employee Stock Purchase Plans supplemented by the provision for discretionary payment of Special Death Benefits. This Court's conclusions in *LoBue* are not framed in terms of reduced purchase price of the stock but in the appropriate terms of benefits bestowed in any fashion upon an employee "prompted by the employer's desire to get better work from him" (247). Those conclusions apply in full force to the Special Benefit payments made by Graybar here.

(2)

In *LoBue* this Court held that the transaction though in form a sale was in substance compensation. This Court said (248) "The transaction here was unlike a mere purchase. It was not an arm's length transaction between strangers. Instead it was an arrangement by which an employer transferred valuable property to his employees in recognition of their services. We hold that LoBue realized gain when he purchased the stock".

In *National Clothing Co. of Rochester, Inc.* v. *Commissioner*, 23 T. C. 944 (acquiesced in C. B. 1956-1, 5) the Tax

Court held that amounts paid by a corporation to stockholder-employees to repurchase its stock pursuant to the corporation's option were compensation deductible by the corporation to the extent that, as here, such amounts exceeded the original purchase price of the stock to the stockholder-employees. There, as here, only employees were eligible to purchase the stock; the stock purchase contracts gave the company the right to repurchase the shares upon the termination of their employment and the employees were not free to dispose of their shares except to the corporation. The transactions were not expressly characterized as additional compensation. Nevertheless, the Tax Court held that additional compensation was paid, saying, p. 949:

> "* * * these transactions, although in form sales, were in substance not sales but rather a means of compensating these employees for the services which they were expected to render to the corporation so that it would prosper and the book value of its stock would increase, thus benefiting both employer and employee * * *".

The holdings of the Courts below are thus also in direct conflict with the holding in the *National Clothing Co.* case which embodies the principles subsequently laid down by this Court in *LoBue*.

Here the resales to the Company of its stock pursuant to its repurchase option, though, in form, sales, were, in substance, compensation. The Courts below have held that the Special Death Benefit payments were additions to the repurchase price on the reacquisition by Graybar of the stock pursuant to its repurchase option. The Tax Court found (R. 26) that the stock "could not be sold, except to the petitioner, and then only at its par value of $20 a share". Under this finding therefore the employee did

not receive any additional compensation or gain until payments of the Special Death Benefits in excess of the repurchase price were made by way of increase in the repurchase price of the stock in excess of the original $20 purchase price. This increase in the repurchase price of the stock thus necessarily became, when received, ordinary income taxable as additional compensation to the employee under the broad coverage of Section 22(a) and correspondingly deductible as a business expense to the employer under Section 23(a). However regarded, therefore, whether as additions to the repurchase price or otherwise, the Special Death Benefit payments were compensatory in nature.

This Court held in *Commissioner* v. *Smith*, 324 U. S. 177, 181—and reaffirmed that holding in *LoBue* (247)—that Section 22(a) "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected". This is the form of the statute itself defining gross income to include compensation for personal services "of whatever kind and in whatever form paid".

As this Court said in *LoBue*, 246, "We have repeatedly held that in defining 'gross income' as broadly as it did in Section 22(a) Congress intended to tax all gains except those specifically exempted".

In *LoBue*, there being no restriction on the employee's sale of the stock after the option's exercise and no repurchase option by the employer, the gain which this Court held taxable to the employee as ordinary income was realized immediately when the employee received property of a value in excess of the amount paid for it, namely, when, by exercising his option, he received stock of a market value in excess of the option purchase price. The taxable income which accrued to the employee there accrued on the original sale

by the employer to the employee. Here it accrued on, or as an incident to, the resale pursuant to the employer's repurchase option by the employee to the employer when the Special Death Benefit payments were made in excess of $20 a share, the fair market value of the stock. The gain which the employee received in *LoBue* was in the form of stock rather than money as in the case at bar. But this is a distinction without a difference because as this Court said (p. 247) "It makes no difference that the compensation is paid in stock rather than in money", the converse of which must necessarily also be true. There is thus no difference in principle between the two cases, the only factual differences being the character of the property transferred and the time when the taxable transfer occurred. As this Court said in *LoBue*, 248, when a transaction is in reality compensation though given the form of a purchase it is taxable as ordinary income under Section 22(a). This applies directly to the Special Death Benefit payments, held by the lower Courts to have been made here as an increase of the repurchase price of the stock, when those payments were received. The time when the taxable transfers here occurred was when Special Death Benefit payments were received by their recipients in excess of the $20 fair market value of the stock purchased by Graybar under its repurchase option.

(3)

This Court rejected the contention, *LoBue* (247), that the transfers did not constitute taxable income on the ground that one purpose of the employer was to confer a 'proprietary interest', saying (247) "But there is not a word in Section 22(a) which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there

is no statutory basis for the test established by the courts below".

By the same token there is no statutory basis for the test established by the Tax Court here that the Special Death Benefits did not come within the broad coverage of Section 22(a) because made "to mitigate the hardship caused by the sale of the stock at a price that was less than its true value" (R. 26), nor is there any statutory basis for the test established by the Court of Appeals that the Special Death Benefit payments were not compensation because they "were strictly an *attribute* of the stock" (R. 162). Both holdings are therefore further in direct conflict with the principle of this Court's decision in *LoBue* by creating a category for which there is no statutory basis.

(4)

The statement in the Court of Appeals' second Opinion, in attempting to distinguish this Court's decision in *LoBue* on the ground that "here there was no proof that the repurchase price, including 'Special Death Benefits' exceeded the fair market value of the shares reacquired by the taxpayer from the estate of its deceased employees" (R. 177-178), constitutes an error of fact and of law on its part. At the time of the employee-stockholder's death the Company's right to repurchase the stock under its repurchase option for its original price of $20 per share had become fixed and unconditional. (R. 16, 17) The Tax Court found (R. 26) that "* * * all of the stock was * * * subject to severe restrictions. It could not be sold, except to petitioner, and then only at its par value of $20 a share. After the death of a stockholder, the estate of the decedent was required to offer to sell the stock to the petitioner at $20 a share." Under precisely similar circumstances where stock was sold by a corporation subject to its option

to repurchase it at par, this Court held in *Helvering* v. *Salvage*, 297 U. S. 106, that for income tax purposes (109) "Considering the option to repurchase at par, outstanding in 1922, there could be no proper finding of fair market value at that time in excess of $100 per share". So here there could be no proper finding that the market value of the stock exceeded $20 a share, the amount paid on reacquisition of the stock, and consequently all of the Special Death Benefit payments, over and above that amount, were in excess of that market value. Thus in holding that this Court's decision in *LoBue* was inapplicable for the erroneous reason given by the Court of Appeals its Opinion conflicts with this Court's decisions both in that case and in the *Salvage* case.

(5)

Neither the broad coverage of Section 22(a), nor the provisions of Section 23(a) impose any condition that in order for payments to employees to constitute compensation such payments must be made to all employees or that it must be shown that there are not other employees not receiving such payments who may have performed equally meritorious services. Yet the Court of Appeals held (R. 161-162) "An employee not owning stock could by even more meritorious service have made a greater contribution to the company yet his estate would have received no special death benefit payments" and repeated in its second Opinion (R. 178) the Tax Court's argument that "Nothing in the record before us forms the basis for a conclusion that the employees who were also stockholders rendered any special services justifying financial recognition that discriminated against other employees."

The holdings of the Tax Court and of the Court of Appeals in this regard are in direct conflict with the Statute and with the decision of this Court in *LoBue* because in that case the benefits received were accorded only to a limited group of selected key employees and were thus not shared in by other employees who as the Court of Appeals said here in its first Opinion "could by even more meritorious services have made a greater contribution to the Company" (R. 161).

Such holdings are further in direct conflict with the decision of the Fourth Circuit in *C. I. R.* v. *R. J. Reynolds Tobacco Co.*, 260 F. (2) 9, which affirmed the Tax Court which had held, 15 T. C. M. 818, that stock options were compensatory though finding that "Of the employees who were afforded essentially equal opportunity to obtain stock, some exercised their privilege while others did not", and with the decision of the Tax Court in *Ray A. Nolan* v. *Commissioner*, 12 T. C. M. 1003, holding stock options compensatory, though finding, 1004, that "Some TWA pilots purchased stock under the plan while others did not. The pilots who purchased stock and the others who did not, flew the same flights, did substantially the same amount of work and were paid the same rates of compensation".

Here the privilege of purchasing the Company's stock was open to all its employees under the Stock Purchase Plans and was availed of by a majority of 60%. Tax status cannot be made to depend upon the happenstance of whether some one or more employees fail to exercise that privilege. If this were so, corporate compensatory distributions to employees would escape taxation as income and lose their tax deductibility by the corporate employer simply because a few employees refused to exercise a right which would have entitled them to such payments.

The holdings of the Courts below in this respect, besides conflicting with the Statute and with this Court's and other Circuit Court of Appeals' decisions, introduce confusion into the law. Further they constitute a serious impediment to the full use by corporate employers of the corporations' stock for purposes of employee incentive compensation plans and, unless reversed, will have a deterrent effect on their future adoption contrary to the public policy which favors their promotion.

(6)

The holdings below give rise to a further ground for certiorari under this Court's Rule 19 because the lower Courts have "so far departed from the accepted and usual course of judicial proceeding, or so far sanctioned such a departure • • •", "as to call for an exercise of this Court's power of supervision". The objection was stressed by the Tax Court (R. 26, 27) that a number of employees did not purchase stock and that "*if* identical services" were performed by two employees only one of whom was a stockholder no benefit payment would be made to the employee who was not a stockholder. The Tax Court further held that "Nothing in the record before us forms the basis for a conclusion that the employees who were also stockholders rendered any special services justifying financial recognition that discriminated against other employees • • •". (R. 28.) The Court of Appeals sanctioned the first holding by its first Opinion affirming the Tax Court "for the reasons stated in his (the Tax Court's) Opinion" (R. 162), and expressly sanctioned the second holding by quoting and approving it in its second Opinion (R. 178).

Both these holdings were in direct violation of the terms of the Commissioner's concession that *qua* compensation the payments were reasonable. Had the pay-

ments "discriminated against other employees", as the Ta
Court held (R. 28), or had there been other employees n
receiving such payments who "could by even more me
torious service have made a greater contribution to t
Company" (R. 161), as the Court of Appeals held, tho
facts in and of themselves would further necessarily hav
rendered the Special Death Benefit payments actually ma
here unreasonable. The necessary effect, therefore, of t
Commissioner's concession of reasonableness *qua* co
pensation of the payments is that the payments actuall
made were reasonable *qua* compensation and the low
Courts' holdings were thus directly violative of the Stipul
tion.

Both holdings were further not based on anything in th
record to show that there were, in fact, other employees wh
"performed identical services". It was a mere gues
Most of the employees whose beneficiaries were recipient
of the payments (Ex. 30 D. D., R. 150) had serve
the Company for 20 years or over. The list of decease
employees and their key positions is exhaustive. Ther
is no proof nor presumption that there were others "per
forming identical services". The presumption was th
other way because the Employees' Benefit Committe
selected and approved the recipients of the Special Death
Benefit payments as eligible therefor. The Tax Court make
and the Court of Appeals adopts the inference, unsupporte
by the record, that there were in fact other employees per
forming identical services. The lower Courts flouted th
Commissioner's concession of reasonableness *qua* compen
sation of the payments and decided the issue on matters
not appearing in the record.

B.

General Importance of the Questions Involved

(1) The decisions below are in direct conflict with this Court's decisions, with the decisions of other Circuit Courts of Appeals, and with the provisions of Section 22(a) and 23(a) of the Code of Internal Revenue of 1939, as amended. Accordingly they involve questions concerning the meaning of the federal income tax statute which are of general importance to the public as distinguished from the parties. This Court granted certiorari in *LoBue* because of just such questions, saying: "We granted certiorari to consider whether the Tax Court and the Court of Appeals had given section 22(a) too narrow an interpretation, 350 U. S. 893" (*LoBue*, 246). The lower Courts have clearly done so here.

(2) The decisions below, unless reviewed and reversed, will constitute precedents introducing confusion of far reaching consequence concerning the tax status of employee compensation plans. The question is one of recurring importance.

Conclusion.

For the foregoing reasons, it is submitted that the Petition for a Writ of Certiorari should be granted.

Dated: June 30, 1959

Respectfully submitted,

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Appendix A.

TREASURY REGULATION 111:

"Sec. 29.23(a)-6. Compensation for personal services —Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. * * *.

"Sec. 29.23(a)-9. Pensions * * *. Amounts paid by a taxpayer for pensions to retired employees or to their families or others dependent upon them. * * * are proper deductions as ordinary and necessary expenses. * * * When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted. * * *".

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515283—59

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 161

GRAYBAR ELECTRIC COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3–29) are reported at 29 T.C. 818. The first opinion of the Court of Appeals (R. 160) and the second opinion denying the taxpayer's petition for rehearing (R. 177) are not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on April 13, 1959. (R. 164.) A petition for rehearing was denied on June 12, 1959. (R. 180.) The petition for a writ of certiorari was filed on July 1, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the record supports the Tax Court's finding, affirmed by the court below, that payments by the taxpayer to repurchase its stock from the estates of deceased shareholder-employees were in fact paid for the stock and not for services of the employees, with the result that the taxpayer was not entitled to deduct the payments as compensation for services under Section 23(a)(1)(A) of the 1939 Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * * *
>
> (26 U.S.C. 1952 ed., 23(a).)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.23(a)-6. *Compensation for Personal Services.*— Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compen-

sation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

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STATEMENT

All of the taxpayer's stock is owned by approximately 60% of its employees, who have purchased it

under various plans at $20 a share. (R. 17, 24, 26.) Under the terms of the purchase plans, the stockholder-employees are obligated to offer their holdings to the taxpayer before selling to any one else, and, in the event of death, the taxpayer has an option to purchase the stock from the estates of the employees or from their beneficiaries. (R. 16–17.) Before 1938 the taxpayer paid as the repurchase price approximately the actual value of the stock, which was always more than $20. (R. 6–8, 13–14.) Since then, the purchase price has been set at the price at which the stock was issued, $20 a share. (R. 13–14.) For the taxable years involved the book value of the stock has been much in excess of this figure (R. 23) and the annual dividend on the stock amounted to $4.20 a share.

Under a corporate resolution adopted in August, 1941, and revised in September, 1947, the taxpayer has authorized the payment of "Special Death Benefits" to the estates or beneficiaries of deceased employee-stockholders whose stock is acquired by the taxpayer. (R. 20–23.) These provisions were substituted for a plan, adopted in May, 1941, providing for substantially the same payments as an "increase in the purchase price" for stock purchased from the estates of stockholders. (R. 27.) The additional payments are measured by the amount of dividends on the outstanding stock which is paid in the five years succeeding the purchase. (R. 20, 22.)

The taxpayer paid "Special Death Benefits" upon the repurchase of its stock during the taxable years in issue in the following amounts (R. 24):

1947	$77,812
1948	85,709
1949	77,294
1950	93,852

and claimed these amounts as deductions for ordinary and necessary expenses paid as compensation for services rendered. (R.24.)

The Tax Court denied the taxpayer's claimed deductions, finding and holding that the taxpayer did not meet its burden of showing that the payments were made purely for services actually rendered. (R. 29.) The Court of Appeals affirmed. (R. 163–164.)

ARGUMENT

The decision that the payments did not constitute compensation for services actually rendered is correct and is not in conflict with any decision of this Court or with any other appellate court decision.

It is clear that the burden of establishing a deduction is on the taxpayer. *Bochm* v. *Commissioner*, 326 U.S. 287. In order to meeet the requirements of Section 29.23(a)–6 of Treasury Regulations 111, *supra*, pp. 2–3, the taxpayer must establish that the payments were in fact made for services actually rendered and that they were reasonable in amount.[1] The determination whether the stipulated evidentiary facts add up to a

[1] The parties entered into a stipulation before the Tax Court (R. 39) that states that assuming, without admitting, that the amounts in question were *paid purely for services*, then the "said payments shall not be disallowed as deductions from gross income on the ground that the same constitute unreasonable allowances for compensation for personal services." The taxpayer contends that because of that stipulation (Pet. 16–17), the courts below erred in considering the fact that under the plan for "Special Death Benefits", although two employees

payment for services or a payment of additional price for the stock depends on an appraisal of the significance of these facts. *Botany Mills* v. *United States*, 278 U.S. 282, 290.

The evidence fully warrants the Tax Court's conclusion that no part of the payments in dispute was shown by the taxpayer to have been made for services rendered by the deceased employees, but, on the contrary, as the purchase price of the stock. The board of directors' meetings of the taxpayer leading up to and including the meeting authorizing the "Special Death Benefits" unequivocally show that the payments were to constitute part of the purchase price for stock of deceased employees in order to give the shareholders a higher price for their investments in the corporation. (R. 136, 146, 147, 148.) Moreover, the amount of the payments depended upon the amount of stock repurchased by the taxpayer (R. 16, 18, 20), and the only occasion for the payments was the taxpayer's repurchase of the shares (R. 18, 136, 146, 147, 148). Shareholders who performed identical services and were entitled to purchase the same amount of stock could purchase varying amounts, but when their shares were resold to the taxpayer they were to receive the payments according to the number

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rendered identical services, only the one who owned stock and sold it back to the taxpayer could receive such benefits, as indicating that the payments were for the stock and not for the value of services rendered. That contention has no merit. It is clear that the differences in treatment between stockholder and nonstockholder-employees has a direct bearing on whether the payments were in fact made for services. The stipulation was not intended to preclude consideration of such matter.

of shares resold and not as measured by the value of their services (R. 20, 27, 150–152). The more than 40% of the employees who purchased no stock at all were not entitled to any of the payments because they owned no stock to sell to the taxpayer (R. 24, 27, 105). The holding of the court below (R. 161–162, 178), based upon its review of all the facts and affirming the finding of the Tax Court, is therefore clearly supported by the record.

There is no conflict with *Commissioner* v. *LoBue*, 351 U.S. 243, and *Commissioner* v. *Smith*, 324 U.S. 177 (Pet. 8–14). Those cases involved options to corporate employees to purchase stock at prices below the market value; the employees were being given a very substantial financial benefit on the basis of their services to their employer. The petitioner's assertion that here the stock was being repurchased at a price in excess of its market value (Pet. 4, 13–14) is based on the misconception that because the contract originally obligated the employees to resell the stock at $20, that automatically sets the market value. If the petitioner is right that the obligation to resell to the taxpayer sets a ceiling on the market value, then the resolution providing for additional payment automatically raises that ceiling.[2] Actually, there is no finding by either court as to what the market value

[2] In asserting a conflict with *Helvering* v. *Salvage*, 297 U.S. 106, the petitioner fails to recognize that in that case the corporation's authority to repurchase at par was not raised to a higher figure so that it in fact fixed a ceiling for the value of the stock.

of the stock was and the petitioner cannot validly base any argument on the proposition that payments in excess of market value were authorized. The burden of proof was on the petitioner and nothing appears to show that the taxpayer paid more than the stock was worth. Therefore, the special incentive feature of *LoBue* and *Smith* is entirely absent here.[3]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1959.

[3] The asserted conflict with *Commissioner* v. *R. J. Reynolds Tobacco Co.*, 260 F. 2d 9 (C.A. 4) is also nonexistent. There, as here, the Tax Court and the Court of Appeals treated part of the payments made to employee-stockholders as compensation and part as a return on their stock (there a dividend rather than part of the purchase price) depending on whether it was in fact made for services or not.